

§ 1.861-10T

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§ 1.861-9T (j), the Y stock must be characterized under the gross income method described in § 1.861-12T(c)(3)(iii). Y's gross income net of interest expense is determined as follows:

Foreign source high withholding tax interest income
 $= \$5,000 - [(\$15,000) \text{ multiplied by } (\$5,000) / (\$5,000 + \$20,000)]$
 $= \$2,000$
 and
 Foreign source general limitation income
 $= \$20,000 - [(\$15,000) \text{ multiplied by } (\$20,000) / (\$5,000 + \$20,000)]$
 $= \$8,000.$

(c) Therefore, \$192 $[(\$960 \times \$2,000) / (\$2,000 + \$8,000)]$ of X's third party interest expense is allocated to foreign source high withholding tax interest income and \$768

$[(\$960 \times \$8,000) / (\$2,000 + \$8,000)]$ is allocated to foreign source general limitation income.

(v) As a result of these direct allocations, for purposes of apportioning X's remaining interest expense under § 1.861-9T, the value of X's assets generating foreign source general limitation income is reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign source general limitation income (\$7,680), and the value of X's assets generating foreign source high withholding tax interest income is reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign source high withholding tax interest income (\$1,920), determined as follows:

Reduction of X's assets generating foreign source general limitation income:

$$\text{X's allocable related group indebtedness} \times \frac{\text{Y's Foreign source general limitation income}}{\text{Y's Foreign source income}}$$

$$\$9,600 \times \$8,000 / (\$8,000 + \$2,000) = \$7,680$$

Reduction of X's assets generating foreign source high withholding tax interest income:

$$\text{X's allocable related group indebtedness} \times \frac{\text{Y's Foreign source high withholding tax interest income}}{\text{Y's Foreign source income}}$$

$$\$9,600 \times \$2,000 / (\$8,000 + \$2,000) = \$1,920$$

[T.D. 8410, 57 FR 13022, Apr. 15, 1992; 57 FR 28012, June 23, 1992]

§ 1.861-10T Special allocations of interest expense (temporary).

(a) *In general.* This section applies to all taxpayers and provides three exceptions to the rules of § 1.861-9T that require the allocation and apportionment of interest expense on the basis of all assets of all members of the affiliated group. Paragraph (b) of this section describes the direct allocation of interest expense to the income generated by certain assets that are subject to qualified nonrecourse indebtedness. Paragraph (c) of this section describes the direct allocation of interest expense to income generated by certain assets that are acquired in integrated finan-

cial transaction. Paragraph (d) of this section provides special rules that are applicable to all transactions described in paragraphs (b) and (c) of this section. Paragraph (e) of this section requires the direct allocation of third party interest of an affiliated group to such group's investment in related controlled foreign corporations in cases involving excess related person indebtedness (as defined therein). See also § 1.861-9T(b)(5), which requires direct allocation of amortizable bond premium.

(b) *Qualified nonrecourse indebtedness*—(1) *In general.* In the case of qualified nonrecourse indebtedness (as defined in paragraph (b)(2) of this section), the deduction for interest shall be considered directly allocable solely to the gross income which the property acquired, constructed, or improved with the proceeds of the indebtedness generates, has generated, or could reasonably be expected to generate.

(2) *Qualified nonrecourse indebtedness defined.* The term “qualified nonrecourse indebtedness” means any borrowing that is not excluded by paragraph (b)(4) of this section if:

(i) The borrowing is specifically incurred for the purpose of purchasing, constructing, or improving identified property that is either depreciable tangible personal property or real property with a useful life of more than one year or for the purpose of purchasing amortizable intangible personal property with a useful life of more than one year;

(ii) The proceeds are actually applied to purchase, construct, or improve the identified property;

(iii) Except as provided in paragraph (b)(7)(ii) (relating to certain third party guarantees in leveraged lease transactions), the creditor can look only to the identified property (or any lease or other interest therein) as security for payment of the principal and interest on the loan and, thus, cannot look to any other property, the borrower, or any third party with respect to repayment of principal or interest on the loan;

(iv) The cash flow from the property, as defined in paragraph (b)(3) of this section, is reasonably expected to be sufficient in the first year of ownership as well as in each subsequent year of ownership to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payments of interest and original issue discount and periodic payments of principal in each such year; and

(v) There are restrictions in the loan agreement on the disposal or use of the property consistent with the assumptions described in subdivisions (iii) and (iv) of this paragraph (b)(2).

(3) *Cash flow defined*—(i) *In general.* The term “cash flow from the prop-

erty” as used in paragraph (b)(2)(iv) of this section means a stream of revenue (as computed under paragraph (b)(3)(ii) of this section) substantially all of which derives directly from the property. The phrase “cash flow from the property” does not include revenue if a significant portion thereof is derived from activities such as sales, labor, services, or the use of other property. Thus, revenue derived from the sale or lease of inventory or of similar property does not constitute cash flow from the property, including plant or equipment used in the manufacture and sale or lease, or purchase and sale or lease, of such inventory or similar property. In addition, revenue derived in part from the performance of services that are not ancillary and subsidiary to the use of property does not constitute cash flow from the property.

(ii) *Self-constructed assets.* The activities associated with self-construction of assets shall be considered to constitute labor or services for purposes of paragraph (b)(3)(i) only if the self-constructed asset—

(A) Is constructed for the purpose of resale, or

(B) Without regard to purpose, is sold to an unrelated person within one year from the date that the property is placed in service for purposes of section 167.

(iii) *Computation of cash flow.* Cash flow is computed by subtracting cash disbursements excluding debt service from cash receipts.

(iv) *Analysis of operating costs.* [Reserved]

(v) *Examples.* The principles of this paragraph may be demonstrated by the following examples.

Example 1. In 1987, X borrows \$100,000 in order to purchase an apartment building, which X then purchases. The loan is secured only by the building and the leases thereon. Annual debt service on the loan is \$12,000. Annual gross rents from the building are \$20,000. Annual taxes on the building are \$2,000. Other expenses deductible under section 162 are \$2,000. Rents are reasonably expected to remain stable or increase in subsequent years, and taxes and expenses are reasonably expected to remain proportional to gross rents in subsequent years. X provides security, maintenance, and utilities to the tenants of the building. Based on facts and circumstances, it is determined that, although services are provided to tenants,

these services are ancillary and subsidiary to the occupancy of the apartments. Accordingly, the cash flow of \$16,000 is considered to constitute a return from the property. Furthermore, such cash flow is sufficient to fulfill the terms and conditions of the loan agreement as required by paragraph (b)(2)(iii).

Example 2. In 1987, X borrows funds in order to purchase a hotel, which X then purchases and operates. The loan is secured only by the hotel. Based on facts and circumstances, it is determined that the operation of the hotel involves services the value of which is significant in relation to amounts paid to occupy the rooms. Thus, a significant portion of the cash flow is derived from the performance of services incidental to the occupancy of hotel rooms. Accordingly, the cash flow from the hotel is considered not to constitute a return on or from the property.

Example 3. In 1987, X borrows funds in order to build a factory, which X then builds and operates. The loan is secured only by the factory and the equipment therein. Based on the facts and circumstances, it is determined that the operation of the factory involves significant expenditures for labor and raw materials. Thus, a significant portion of the cash flow is derived from labor and the processing of raw materials. Accordingly, the cash flow from the factory is considered not to constitute a return on or from the property.

(4) *Exclusions.* The term “qualified nonrecourse indebtedness” shall not include any transaction that—

(i) Lacks economic significance within the meaning of paragraph (b)(5) of this section;

(ii) Involves cross collateralization within the meaning of paragraph (b)(6) of this section;

(iii) Except in the case of a leveraged lease described in paragraph (b)(7)(ii) of this section, involves credit enhancement within the meaning of paragraph (b)(7) of this section or, with respect to loans made on or after October 14, 1988, does not under the terms of the loan documents, prohibit the acquisition by the holder of bond insurance or similar forms of credit enhancement;

(iv) Involves the purchase of inventory;

(v) Involves the purchase of any financial asset, including stock in a corporation, an interest in a partnership or a trust, or the debt obligation of any obligor (although interest incurred in order to purchase certain financial instruments may qualify for direct allo-

cation under paragraph (c) of this section);

(vi) Involves interest expense that constitutes qualified residence interest as defined in section 163(h)(3); or

(vii) [Reserved]

(5) *Economic significance.* Indebtedness that otherwise qualifies under paragraph (b)(2) shall nonetheless be subject to apportionment under § 1.861-9T if, taking into account all the facts and circumstances, the transaction (including the security arrangement) lacks economic significance.

(6) *Cross collateralization.* The term “cross collateralization” refers to the pledge as security for a loan of—

(i) Any asset of the borrower other than the identified property described in paragraph (b)(2) of this section, or

(ii) Any asset belonging to any related person, as defined in § 1.861-8T(c)(2).

(7) *Credit enhancement*—(i) *In general.* Except as provided in paragraph (b)(7)(ii) of this section, the term “credit enhancement” refers to any device, including a contract, letter of credit, or guaranty, that expands the creditor’s rights, directly or indirectly, beyond the identified property purchased, constructed, or improved with the funds advanced and, thus effectively provides as security for a loan the assets of any person other than the borrower. The acquisition of bond insurance or any other contract of suretyship by an initial or subsequent holder of an obligation shall constitute credit enhancement.

(ii) *Special rule for leveraged leases.* For purposes of this paragraph (b), the term “credit enhancement” shall not include any device under which any person that is not a related person within the meaning of § 1.861-8T(c)(2) agrees to guarantee, without recourse to the lessor or any person related to the lessor, a lessor’s payment of principal and interest on indebtedness that was incurred in order to purchase or improve an asset that is depreciable tangible personal property or depreciable tangible real property (and the land on which such real property is situated) that is leased to a lessee that is not a related person in a transaction that constitutes a lease for federal income tax purposes.

(iii) *Syndication of credit risk and sale of loan participations.* The term “syndication of credit risk” refers to an arrangement in which one primary lender secures the promise of a secondary lender to bear a portion of the primary lender’s credit risk on a loan. The term “sale of loan participations” refers to an arrangement in which one primary lender divides a loan into several portions, sells and assigns all rights with respect to one or more portions to participating secondary lenders, and does not remain at risk in any manner with respect to the portion assigned. For purposes of this paragraph (b), the syndication of credit risk shall constitute credit enhancement because the primary lender can look to secondary lenders for payment of the loan, notwithstanding limitations on the amount of the secondary lender’s liability. Conversely, the sale of loan participations does not constitute credit enhancement, because the holder of each portion of the loan can look solely to the asset securing the loan and not to the credit or other assets of any person.

(8) *Other arrangements that do not constitute cross collateralization or credit enhancement.* For purposes of paragraphs (b) (6) and (7) of this section, the following arrangements do not constitute cross collateralization or credit enhancement:

(i) *Integrated projects.* A taxpayer’s pledge of multiple assets of an integrated project, provided that the integrated project. An integrated project consists of functionally related and geographically contiguous assets that, as to the taxpayer, are used in the same trade or business.

(ii) *Insurance.* A taxpayer’s purchase of third-party casualty and liability insurance on the collateral or, by contract, bearing the risk of loss associated with destruction of the collateral or with respect to the attachment of third party liability claims.

(iii) *After-acquired property.* Extension of a creditor’s security interest to improvements made to the collateral, provided that the extension does not constitute excess collateralization under paragraph (b)(6), determined by taking into account the value of improvements at the time the improve-

ments are made and the value of the original property at the time the loan was made.

(iv) *Warranties of completion and maintenance.* A taxpayer’s warranty to a creditor that it will complete construction or manufacture of the collateral or that it will maintain the collateral in good condition.

(v) *Substitution of collateral.* A taxpayer’s right to substitute collateral under any loan contract. However, after the right is exercised, the loan shall no longer constitute qualified nonrecourse indebtedness.

(9) *Refinancings.* If a taxpayer refinances qualified nonrecourse indebtedness (as defined in paragraph (b)(2) of this section) with new indebtedness, such new indebtedness shall continue to qualify only if—

(i) The principal amount of the new indebtedness does not exceed by more than five percent the remaining principal amount of the original indebtedness,

(ii) The term of the new indebtedness does not exceed by more than six months the remaining term of the original indebtedness, and

(iii) The requirements of this paragraph (other than those of paragraph (b)(2) (i) and (ii) of this section) are satisfied at the time of the refinancing, and the exclusions contained in this paragraph (b)(4) do not apply.

(10) *Post-construction permanent financing.* Financing that is obtained after the completion of constructed property will be deemed to satisfy the requirements of paragraph (b)(2) (i) and (ii) of this section if—

(i) The financing is obtained within one year after the constructed property or substantially all of a constructed integrated project (as defined in paragraph (b)(9)(i) of this section) is placed in service for purposes of section 167; and

(ii) The financing does not exceed the cost of construction (including construction period interest).

(11) *Assumptions of pre-existing qualified nonrecourse indebtedness.* If a transferee of property that is subject to

qualified nonrecourse indebtedness assumes such indebtedness, the indebtedness shall continue to constitute qualified nonrecourse indebtedness, provided that the assumption in no way alters the qualified status of the debt.

(12) *Excess collateralization.* [Reserved]

(c) *Direct allocations in the case of certain integrated financial transactions*—(1) *General rule.* Interest expense incurred on funds borrowed in connection with an integrated financial transaction (as defined in paragraph (c)(2) of this section) shall be directly allocated to the income generated by the investment funded with the borrowed amounts.

(2) *Definition.* The term “integrated financial transaction” refers to any transaction in which—

(i) The taxpayer—

(A) Incurs indebtedness for the purpose of making an identified term investment,

(B) Identifies the indebtedness as incurred for such purpose at the time the indebtedness is incurred, and

(C) Makes the identified term investment within ten business days after incurring the indebtedness;

(ii) The return on the investment is reasonably expected to be sufficient throughout the term of the investment to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payments of principal and interest or original issue discount;

(iii) The income constitutes interest or original issue discount or would constitute income equivalent to interest if earned by a controlled foreign corporation (as described in § 1.954-2T(h));

(iv) The debt incurred and the investment mature within ten business days of each other;

(v) The investment does not relate in any way to the operation of, and is not made in the normal course of, the trade or business of the taxpayer or any related person, including the financing of the sale of goods or the performance of services by the taxpayer or any related person, or the compensation of the taxpayer’s employees (including any contribution or loan to an employee stock ownership plan (as defined in section 4975(e)(7)) or other plan that is qualified under section 401(a)); and

(vi) The borrower does not constitute a financial services entity (as defined in section 904 and the regulations thereunder).

(3) *Rollovers.* In the event that a taxpayer sells of otherwise liquidates an investment described in paragraph (c)(2) of this section, the interest expense incurred on the borrowing shall, subsequent to that liquidation, no longer qualify for direct allocation under this paragraph (c).

(4) *Examples.* The principles of this paragraph (c) may be demonstrated by the following examples.

Example 1. X is a manufacturer and does not constitute a financial services entity as defined in the regulations under section 904. On January 1, 1988, X borrows \$100 for 6 months at an annual interest rate of 10 percent. X identifies on its books and records by the close of that day that the indebtedness is being incurred for the purpose of making an investment that is intended to qualify as an integrated financial transaction. On January 5, 1988, X uses the proceeds to purchase a portfolio of stock that approximates the composition of the Standard & Poor’s 500 Index. On that day, X also enters into a forward sale contract that requires X to sell the stock on June 1, 1988 for \$110. X identifies on its books and records by the close of January 5, 1988, that the portfolio stock purchases and the forward sale contract constitute part of the integrated financial transaction with respect to which the identified borrowing was incurred. Under § 1.954-2T(h), the income derived from the transaction would constitute income equivalent to interest. Assuming that the return on the investment to be derived on June 1, 1988, will be sufficient to pay the interest due on June 1, 1988, the interest on the borrowing is directly allocated to the gain from the investment.

Example 2. X does not constitute a financial services entity as defined in the regulations under section 904. X is in the business of, among other things, issuing credit cards to consumers and purchasing from merchants who accept the X card the receivables of consumers who make purchases with the X card. X borrows from Y in order to purchase X credit card receivables from Z, a merchant. Assuming that the Y borrowing satisfies the other requirements of paragraph (c)(2) of this section, the transaction nonetheless cannot constitute an integrated financial transaction because the purchase relates to the operation of X’s trade or business.

Example 3. Assume the same facts as in Example 2, except that X borrows in order to purchase the receivables of A, a merchant who does not accept the X card and is not

otherwise engaged directly or indirectly in any business transaction with X. Because the borrowing is not related to the operation of X's trade or business, the borrowing may qualify as an integrated financial transaction if the other requirements of paragraph (c)(2) of this section are satisfied.

(d) *Special rules.* In applying paragraphs (b) and (c) of this section, the following special rules shall apply.

(1) *Related person transactions.* The rules of this section shall not apply to the extent that any transaction—

(i) Involves either indebtedness between related persons (as defined in section §1.861-8T(c)(2)) or indebtedness incurred from unrelated persons for the purpose of purchasing property from a related person; or

(ii) Involves the purchase of property that is leased to a related person (as defined in §1.861-8T(c)(2)) in a transaction described in paragraph (b) of this section. If a taxpayer purchases property and leases such property in whole or in part to a related person, a portion of the interest incurred in connection with such an acquisition, based on the ratio that the value of the property leased to the related person bears to the total value of the property, shall not qualify for direct allocation under this section.

(2) *Consideration of assets or income to which interest is directly allocated in apportioning other interest expense.* In apportioning interest expense under §1.861-9T, the year-end value of any asset to which interest expense is directly allocated under this section during the current taxable year shall be reduced to the extent provided in §1.861-9T(g)(2)(iii) to reflect the portion of the principal amount of the indebtedness outstanding at year-end relating to the interest which is directly allocated. A similar adjustment shall be made to the end-of-year value of assets for the prior year for purposes of determining the beginning-of-year value of assets for the current year. These adjustments shall be made prior to averaging beginning-of-year and end-of-year values pursuant to §1.861-9T(g)(2). In apportioning interest expense under the modified gross income method, gross income shall be reduced by the amount of income to which interest expense is directly allocated under this section.

(e) *Treatment of certain related controlled foreign corporation indebtedness—*

(1) *In general.* In taxable years beginning after 1987, if a United States shareholder has incurred substantially disproportionate indebtedness in relation to the indebtedness of its related controlled foreign corporations so that such corporations have excess related person indebtedness (as determined under step 4 in subdivision (iv) of this paragraph (e)(1), the third party interest expense of the related United States shareholder (excluding amounts allocated under paragraphs (b) and (c)) in an amount equal to the interest income received on such excess related person indebtedness shall be allocated to gross income in the various separate limitation categories described in section 904(d)(1) in the manner prescribed in step 6 in subdivision (vi) of this paragraph (e)(1). This computation shall be performed as follows.

(i) *Step 1: Compute the debt-to-asset ratio of the related United States shareholder.* The debt-to-asset ratio of the related United States shareholder is the ratio between—

(A) The average month-end debt level of the related United States shareholder taking into account debt owing to any obligee who is not a related person as defined in section §1.861-8T(c)(2), and

(B) The value of assets (tax book or fair market) of the related United States shareholder including stockholdings and obligations of related controlled foreign corporations but excluding stockholdings and obligations of members of the affiliated group (as defined in §1.861-11T(d)).

(ii) *Step 2: Compute aggregate debt-to-asset ratio of all related controlled foreign corporations.* The aggregate debt-to-asset ratio of all related controlled foreign corporations is the ratio between—

(A) The average aggregate month-end debt level of all related controlled foreign corporations for their taxable years ending during the related United States shareholder's taxable year taking into account only indebtedness owing to persons other than the related United States shareholder or the related United States shareholder's other

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related controlled foreign corporations (“third party indebtedness”), and

(B) The aggregate value (tax book or fair market) of the assets of all related controlled foreign corporations for their taxable years ending during the related United States shareholder’s taxable year excluding stockholdings in and obligations of the related United States shareholder or the related United States shareholder’s other related controlled foreign corporations.

(iii) *Step 3: Compute aggregate related person debt of all related controlled foreign corporations.* This amount equals the average aggregate month-end debt level of all related controlled foreign corporations for their taxable years ending with or within the related United States shareholder’s taxable year, taking into account only debt which is owned to the related United States shareholder (“related person indebtedness”).

(iv) *Step 4: Computation of excess related person indebtedness and computation of the income therefrom—(A) General rule.* If the ratio computed under step 2 is less than applicable percentage of the ratio computed under step 1, the taxpayer shall add to the aggregate third party indebtedness of all related controlled foreign corporations determined under paragraph (e)(1)(ii)(A) of this section that portion of the related person indebtedness computed under step 3 that, when combined with the aggregate third party indebtedness of all controlled foreign corporations, makes the ratio computed under step 2 equal to applicable percentage of the ratio computed under step 1. The amount of aggregate related person debt that is so added to the aggregate

third party debt of related controlled foreign corporations is considered to constitute excess related person indebtedness. For purposes of this paragraph (e)(1)(iv)(A), the term “applicable percentage” means the designated percentages for taxable years beginning during the following calendar years:

| Taxable years beginning in | Applicable percentage |
|----------------------------|-----------------------|
| 1988 | 50 |
| 1989 | 65 |
| 1990 and thereafter | 80 |

(B) *Elective quadratic formula.* In calculating the amount of excess related party indebtedness of related controlled foreign corporations, the United States shareholder’s debt-to-asset ratio may be adjusted to reflect the amount by which its debt and assets would be reduced had the related controlled foreign corporations incurred the excess related party indebtedness directly to third parties. In such case, the ratio computed in Step 1 is adjusted to reflect a reduction of both portions of the ratio by the amount of excess related person indebtedness as computed under this paragraph (e)(1)(ii)(A). Excess related person indebtedness may be computed under the following formula, under which excess related person indebtedness equals the smallest positive amount (not exceeding the aggregate amount of related controlled foreign corporation indebtedness) that is a solution to the following formula (with X equalling the amount of excess related person indebtedness):

$$\frac{\text{Aggregate third party debt of related US shareholder} - X}{\text{US shareholder assets} - X} \times \text{Applicable percentage for year} = \frac{\text{Aggregate third party debt of related CFCs} + X}{\text{Related CFC assets}}$$

Guidance concerning the solution of this equation is set forth in *Example (2)* of § 1.861-12(k).

(C) *Computation of interest income received on excess related party indebtedness.* The amount of interest income re-

ceived on excess related person indebtedness equals the total interest income on related person indebtedness derived

by the related United States shareholder during the taxable year multiplied by the ratio of excess related person indebtedness over the aggregate related person indebtedness for the taxable year.

(v) *Step 5: Determine the aggregate amount of related controlled foreign corporation obligations held by the related United States shareholder in each limitation category.* The aggregate amount of related controlled foreign corporation obligations held by the related United States shareholder in each limitation category equals the sum of the value of all such obligations in each limitation category. Solely for purposes of this paragraph (e)(1)(v), each debt obligation in a related controlled foreign corporation held by a related United States shareholder shall be attributed to separate limitation categories in the same manner as the stock of the obligor would be attributed under the rules of § 1.861-12T(c)(3), whether or not such stock is held directly by such related United States shareholder.

(vi) *Step 6: Direct allocation of United States shareholder third party interest expense.* Third party interest expense of the related United States shareholder equal to the amount of interest income received on excess related person indebtedness as determined in step 4 shall be allocated among the various separate limitation categories in proportion to the relative aggregate amount of related controlled foreign corporation obligations held by the related United States shareholder in each such category, as determined under step 5. The remaining portion of third party interest expense will be apportioned as provided in §§ 1.861-8T through 1.861-13T, excluding this paragraph.

(2) *Definitions*—(i) *United States shareholder.* For purposes of this paragraph, the term “United States shareholder” has the same meaning as defined by section 957, except that, in the case of a United States shareholder that is a member of an affiliated group (as defined in § 1.861-11T(d)), the entire affiliated group shall be considered to constitute a single United States shareholder. The term “related United States shareholder” is the United States shareholder (as defined in this paragraph

(e)(2)(i)) with respect to which related controlled foreign corporations (as defined in paragraph (e)(2)(ii) of this section) are related within the meaning of that paragraph.

(ii) *Related controlled foreign corporation.* For purposes of this section, the term “related controlled foreign corporation” means any controlled foreign corporation which is a related person (as defined in § 1.861-8T(c)(2)) to a United States shareholder (as defined paragraph (e)(2)(i) of this section).

(iii) *Value of assets and amount of liabilities.* For purposes of this section, the value of assets is determined under § 1.861-9T(g). Thus, in the case of assets that are denominated in foreign currency, the average of the beginning-of-year and end-of-year values is determined in foreign currency and translated into dollars using exchange rates on the last day of the related United States shareholder's taxable year. In the case of liabilities that are denominated in foreign currency, the average month-end debt level of such liabilities is determined in foreign currency and then translated into dollars using exchange rates on the last day of the related United States shareholder's taxable year.

(3) *Treatment of certain stock.* To the extent that there is insufficient related person indebtedness of all related controlled foreign corporations under step 3 in paragraph (e)(1)(iii) of this section to achieve as equal ratio in step 4 of paragraph (e)(1)(iv) of this section, certain stock held by the related United States shareholder will be treated as related person indebtedness. Such stock includes—

(i) Any stock in the related controlled foreign corporation that is treated in the same manner as debt under the law of any foreign country that grants a deduction for interest or original issue discount relating to such stock, and

(ii) Any stock in a related controlled foreign corporation that has made loans to, or held stock described in this paragraph (e)(3) in, another related controlled foreign corporation. However, such stock shall be treated as related person indebtedness only to the extent of the principal amount of such loans.

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For purposes of computing income from excess related person indebtedness in step 4 of paragraph (e)(1)(iv) of this section, stock that is treated under this paragraph as related person indebtedness shall be considered to yield interest in an amount equal to the interest that would be computed on an equal amount of indebtedness under section 1274. Only dividends actually paid thereon shall be included in gross income for other purposes.

(4) *Adjustments to assets in apportioning other interest expense.* In apportioning interest expense under § 1.861-9T, the value of assets in each separate limitation category for the taxable year as determined under § 1.861-9T(g)(3) shall be reduced (but not below zero) by the principal amount of third party indebtedness of the related United States shareholder the interest expense on which is allocated to each such category under paragraph (e)(1) of this section.

(5) *Exceptions—(i) Per company rule.* If—

(A) A related controlled foreign corporation with obligations owing to a related United States shareholder has a greater proportion of passive assets than the proportion of passive assets held by the related United States shareholder,

(B) Such passive assets are held in liquid or short term investments, and

(C) There are frequent cash transfers between the related controlled foreign corporation and the related United States shareholder,

the Commissioner, in his discretion, may choose to exclude such a corporation from other related controlled foreign corporations in the application of the rules of this paragraph (e).

(ii) *Aggregate rule.* If it is determined that, in aggregate, the application of the rules of this paragraph (e) increases a taxpayer's foreign tax credit as determined under section 901(a), the Commissioner, in his discretion, may choose not to apply the rules of this paragraph. If the Commissioner exercises discretion under this paragraph (e)(5)(ii), then paragraph (e) shall not apply to any extent to any interest expense of the taxpayer.

(f) *Effective/applicability date.* (1) In general, the rules of this section apply

for taxable years beginning after December 31, 1986.

(2) Paragraphs (b)(3)(ii) (providing an operating costs test for purposes of the nonrecourse indebtedness exception) and (b)(6) (concerning excess collateralization of nonrecourse borrowings) of this section are applicable for taxable years commencing after December 31, 1988.

(3) Paragraph (e) (concerning the treatment of related controlled foreign corporation indebtedness) of this section is applicable for taxable years commencing after December 31, 1987. For rules for taxable years beginning before January 1, 1987, and for later years to the extent permitted by § 1.861-13T, see § 1.861-8 (revised as of April 1, 1986).

[T.D. 8228, 53 FR 35485, Sept. 14, 1988, as amended by T.D. 9456, 74 FR 38875, Aug. 4, 2009]

§ 1.861-11 Special rules for allocating and apportioning interest expense of an affiliated group of corporations.

(a)–(c) [Reserved]. For further guidance, see § 1.861-11T(a) through (c).

(d) *Definition of affiliated group—(1) General rule.* For purposes of this section, in general, the term *affiliated group* has the same meaning as is given that term by section 1504, except that section 936 corporations are also included within the affiliated group to the extent provided in paragraph (d)(2) of this section. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through 80-percent stock ownership with a common parent corporation which is an includible corporation (as defined in section 1504(b)). In the case of a corporation that either becomes or ceases to be a member of the group during the course of the corporation's taxable year, only the interest expense incurred by the group member during the period of membership shall be allocated and apportioned as if all members of the group were a single corporation. In this regard, assets held during the period of membership shall be taken into account. Other interest expense incurred by the group member during its taxable year but not during